DOW THEORY LETTERS INC.

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Nov 8, DJIA 667.16; PTI 205; A-D ratio -32.08
Nov 15, DJIA 647.61; PTI 191; A-D ratio -38.51

"Nothing happens to anybody which he is not fitted by nature to bear." Marcus Aurelius

THE 1970's: The new expression of the 1970's, the "rip-off". The phenomenon of the early 1970's, double-digit inflation. The new brand of economic slump which is arriving in 1974, the slump brought on by inflation and a collapse in buying power. The coming new concept of the 1970's, confiscation of wealth via taxation, government edict and "redistribution of incomes".

But probably the biggest surprises have yet to appear. I see them as (1) deflation in prices, and (2) a drastic downward revision in standards of living. As to the first (deflation), the stock market has seen this coming for months. In fact, if one insists on a reason for the rally in the market since October (and I don't usually like "reasons" for rallies), I would say that the rally was based on the market's discounting the end of inflation. Now the good news is that the end of inflation (even if on a temporary basis) is a healthy development for the country. The bad news is that deflation is going to be as painful as inflation (or rather the forces which make for deflation are going to be just as painful).

As to the revision in living standards, it is ironic that the man on the street may have more savvy regarding what is coming up than does the man in the corporate boardroom. This news clip from the Phillips-Sindlinger Survey indicates that the common man is at least capable of adding up two and two, and then pulling in his belt a few notches. I feel that the consumer is now on the verge of a big change in living habits, brought on partly by desire and partly by necessity. At any rate, Mr. America is about to take his Alka-Seltzer. He is reasonably sure that the party is over, and he wants to go into 1975 cold sober.

THE PHILLIPS-SINDLINGER SURVEY

Deflation May Be On Way

With U.S. inflation woes shifting to depression fears, consumers are reporting declining prices in many items and commodities, and the beginnings of deflation may be at hand.

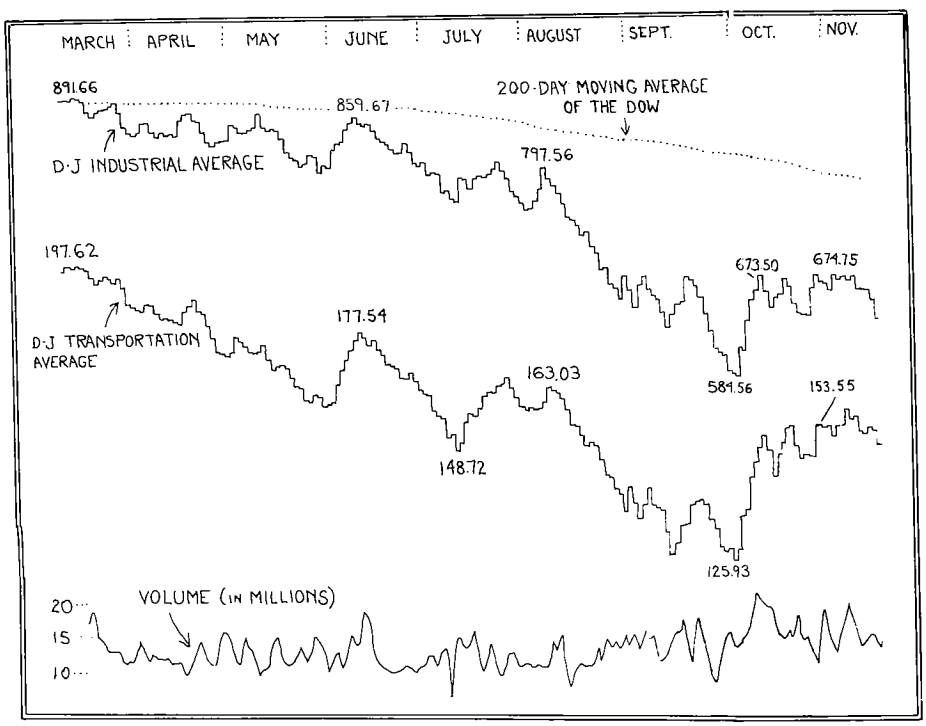
These and other profiles of price behavior emerged in a nationwide Phillips-Sindlinger telephone poll of 1,679 persons taken between Oct. 19-28.

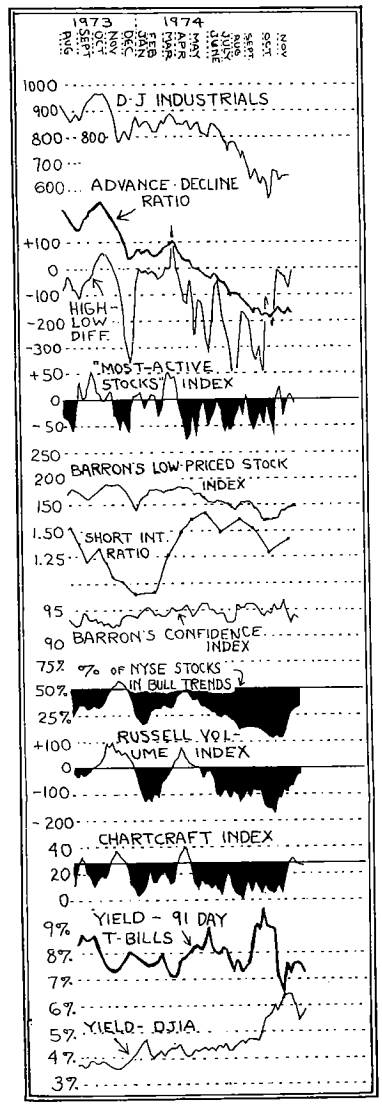
cent said that interest rates were coming down, 17 per cent mentioned sea food prices, 15 per cent cited clothing costs, 14 per cent mentioned bread prices and 14 per cent thought vegetable prices were easing.

Further down the list came the cost of eggs (13 per cent), milk (13 per cent), poultry (12 per cent), fruit (11 per cent), food in general (11 per cent), travel and vacation plans (17 per cent), television sets (15 per cent), and new homes (14 per cent).

When we asked how people were coping with the way that food prices had increased in the last year, 53 per cent said they were eating less meat in general and beef in particular, and 30 per cent said they were

But it is the huge, built-in corporate and Government financial structure which is going to be squeezed by deflation. That structure is debt structure, a structure which must be serviced by taxes (for the government) and profits (for business). During a deflationary recession period, profits collapse and the Government tax-take goes with it. When this happens, we can expect (1) a credit crisis, (2) an unprecedented scramble for cash and liquidity, (3) rising interest rates and a declining bond market, (4) widespread distress and liquidation as the third phase of the bear market hits full force.





DOW THEORY: On a strict reading of the Averages with volume implications, I would say that over the past month we have been seeing "churning". Churning is Wall Street's term for "much ado about nothing" or alot of activity with no price movement (distribution). The Industrial Average rose from 584.66 on October 4 to 673.50 on October 14, a gain of 89 points in six trading days. In the twenty-four days since October 14, the Dow has gone nowhere. The Transports (see chart on page 1) have trended generally upward since their October 14 peak, but as Dow's Theory states, a movement of one Average unconfirmed by a comparable movement in the other, is useless for prediction purposes and is more often than not deceptive.

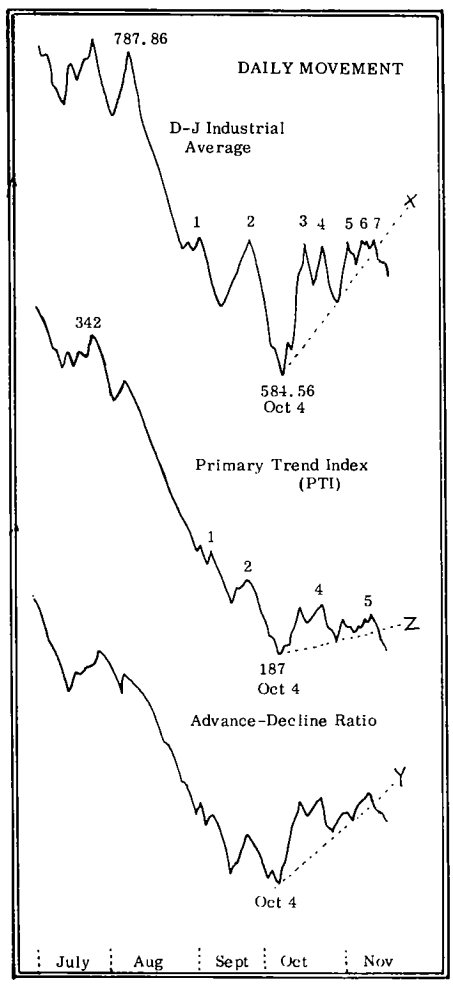
PSYCHOLOGICAL: During the whole August to November period, wide publicity was given to the "head-and-shoulders bottom" pattern which had formed in the Dow. In the last Letter I began by saying that I have never seen such wide mention made of a stock market formation. If the Australians, Russians and Swiss knew nothing of head-and-shoulders bottoms prior to Autumn 1974, they are well up on them now. Which is another way of saying that when the market refuses to live up to its advance billing, it is usually preparing for one of its ornery little surprises.

For months the stock market "experts" have been saying "Just wait for interest rates to ease, just you wait. As soon as they do, the stock market will take off like a ...." Now interest rates and the prime rate are coming down and would you believe it, the whole thing has been thoroughly discounted. Obviously, the market is looking beyond the simple process of interest rates coming down. It is looking at the gathering business smash which has indeed brought interest rates down. I take it as ominous that the market is declining as interest rates recede.

TECHNICAL: I want to go into the technical aspect of this market in a little more detail, and I have therefore included a chart showing the daily closing of the D-J Industrial Average, plus the daily tallies for the Primary Trend Index (PTI) and the advance-decline ratio. The chart covers the period of the past five months.

It is worth noting that the Dow since August has pushed into the 665-675 zone on seven separate occasions, and I have marked these on the chart. The old market adage states that the market will try something three times, and on the fourth time it will either make it big or fail big. Evidently, Wall Street hasn't been listening. The Dow tried to go through the 665-675 area three times, then a fourth, then three extra for good measure. Following the seventh attempt (see chart), the Dow again turned down, and on November 12 it broke its near-term trend line (X on chart).

Now turn to the PTI, which is my own amalgam of eight critical indicators, including four common stock averages and one bond average, the most-active stocks, the advance-decline ratio and the high-low index. The rise from the October 4 low on the PTI (187) to the peak at point 4 on the chart added only 30 points to the PTI against 89 for the D-J Industrials. This was, at best, a sub-standard effort, and for comparisons I should add that on strong rallies the PTI will gain point for point with the Dow. In this case, for every 2.9 points gained by the Dow, the PTI gained only 1 point.



In the last Letter (page 6) I showed that the PTI was forming a series of declining peaks against the succession of level peaks in the Dow. Since then, the series of divergences has increased, and by November 12th we had seven consecutive Dow peaks against five declining peaks in the PTI, an extraordinary picture of continuing technical deterioration. On November 14 the PTI dropped below its rising trendline (Z on chart). On November 15 the PTI dropped again, this time sinking to within 4 points of its October 4 bear market low (187), in all a most bearish technical performance.

The advance-decline ratio traces the advancing or declining tendency of all NYSE issues. This widely-studied index proved a bit tricky (should I say deceptive) during the October-November period. As seen on the chart, the A-D ratio in November pushed above its October peak, then immediately reversed itself. On November 13 the ratio broke its rising trendline (Y on chart). I now rate the A-D ratio as bearish. In my opinion, the technical situation calls for the Dow to break to new bear market lows (below 584.56) during the period ahead. Any rally should prove to be abortive and would probably be brought on by manipulated "good news".

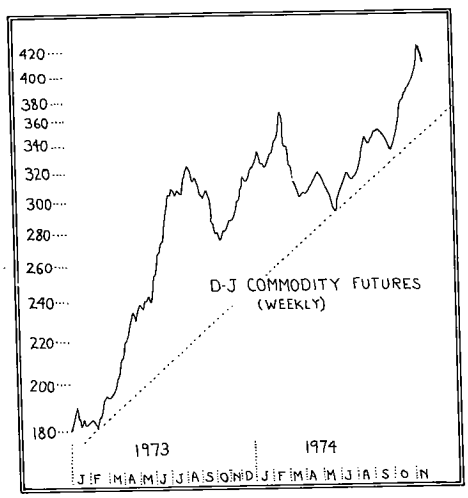
NOTE: On November 15 the London market broke to another 16-year low of 180.9. I consider this to be extremely bearish. It means that the London market is discounting even more horrendous news than that which is now known. Only the powers above know what the ding-bat Britains are planning next. I take the new London low as a bad omen for the US markets (since we have a habit of apeing our overseas cousins, particularly when it comes to outlandish economic schemes).

THE PICTURE: The current period is the first within memory in which the following factors have all come together (1) a soft goods slump, (2) a housing slide, (3) a collapse in auto sales, (4) a big decline in appliance sales, (5) consumers overloaded with installment debt and cutting back, (6) rising unemployment and factory shutdown, (7) a worldwide contraction in business, (8) galloping costs, spearheaded by higher labor and raw material costs, (9) unsatisfactory money conditions, (10) illiquidity in the US and world economies.

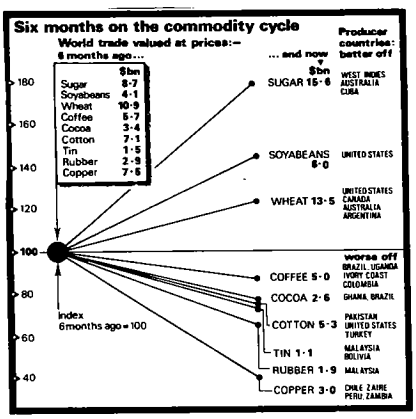
There is a tremendous amount of well-meaning confusion going around these days, plus a goodly portion of hypocrisy and the usual amount of out-and-out lying. As usual, the "name economists" are making their pronouncements. And what these economists think and say is heavily influenced by their own experience. It should be remembered that the vast majority of economists have grown up in the post World War II era, and thus they have seen only recessions or economic set-backs which have occurred within the framework of a primary bull market (for instance, the recessions of 1953-54, 1957-59 or 1960). In each of these recessions there were many strong spots in the economy which served to offset the weak spots. And, of course, behind each of these recessions was the positive force of the great primary bull market, a force which continued in effect all during the period of 1949 to 1966.

Currently, we are dealing with a very different kind of animal. The bear is king now. Our economists and governmental leaders, unfortunately, do not understand what this means. Consequently, we see leading spokesmen coming out with all sorts of hopeful predictions based on the earlier recession experience. It's not going to work, and I feel that they might as well try to predict how a Great Dane is going to react based on studies of wart hogs in Kenya.

In my opinion, the economists, the government leaders and the money managers are going to be shocked by developments as they unfold during the remainder of 1974 and throughout 1975. It would not surprise me to see business go through a real baptism of fire. Along with this, I expect to see increasing consumer resistance to high prices, surging unemployment, a bust in commodity prices, urgent inventory liquidation, severe cutbacks in capital spending, and a decline in corporate earnings which will astound the business world. That's the way primary bear markets work, and as we approach the third phase of this bear market I expect the process to intensify.

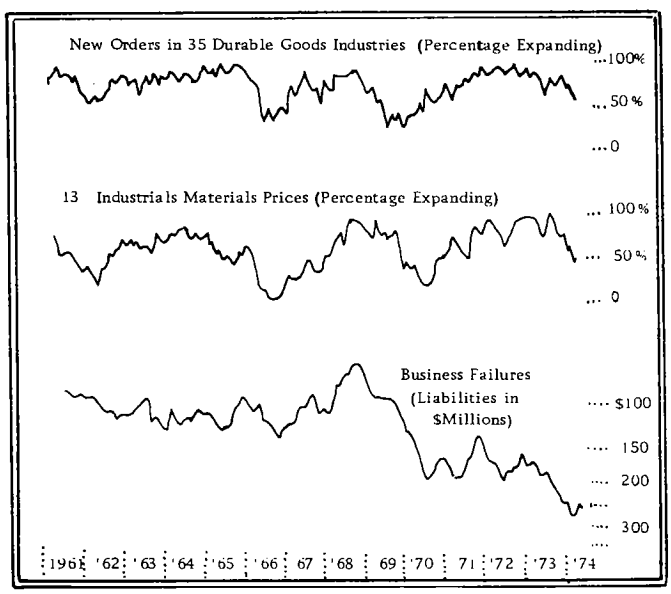


I am including my ratio chart of the D-J Commodity Future Average, now spiking up in what I consider a final blow-off (mainly because of the grains). This food sector is the single greatest area of resistance to the bear, and I feel that the old grizzly is about to raise a powerful paw, a paw that will seek to rip the top off the Commodity Average. The London Economist published this chart showing the current severe divergences in various commodity prices, and I believe that 1975 will see all commodities getting in gear on the downside.

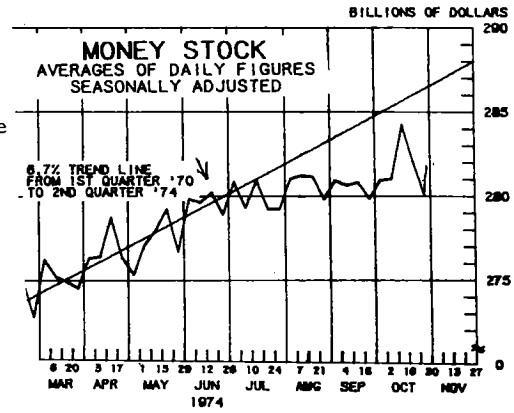


This mailing goes into the economics of the situation a bit more deeply than usual, but I want to prepare my subscribers for the difficulties which I foresee ahead. I have included a chart showing two so-called diffusion indices and one simple quantitative graph. The diffusion index is a device which shows the percentage of items expanding in some given area. If the percentage of expanding figures starts to decline, this usually precedes a drop in the actual price (it works much as a momentum index). The first diffusion index traces the "percentage expanding" in new orders for durable goods. The index is in a definite decline, a sign of impending recession in the economy.

The second diffusion index covers percentage expanding in the price of 13 industrial materials. What we see here is another early sign of deflation. Finally, the bankruptcy graph shows that business failures are skyrocketing during 1974. This chart deals with total dollar amount of bankruptcies. The total is rising (the graph on the chart is inverted) and so far the figures for 1974's first six months are 46% over the first six months of 1973! My bet is that the first six months of 1975 are going to set a record.



Much of what I show above suggests deflation for 1975. The great argument against deflation is that "the Fed won't let it happen; they will simply open the money spigots". And the Fed could certainly do just that. But we should be aware of three factors here. First, the Fed may make more money available, but that is no guarantee that it will do anything for the economy. The banks could conceivably bulge with money, but corporations and business have to be "ready to drink". I don't think they are. Second, easing bank reserves may merely allow the banks to move away from their present extremely illiquid positions.



The banks may not want to lend the money out. They may very well opt for liquidity (frankly, I think the banks are scared to death now). Third, the fact is that the money supply (so far) is not expanding. The accompanying chart from the latest St. Louis Federal Reserve bulletin shows that the money stock (bank deposits plus cash held by the public) has held flat since last June! If we're going to float out of this recession via a sea of green paper, it has not shown up in the figures as of this writing.

My thought here is that the Fed is actually (believe it or not) very much afraid of fanning the fires of inflation, following the disastrous experience of the past decade. So the Fed is proceding cautiously at this time, perhaps hoping for a controllable and even painful temporary recession. This, they feel, will serve to hold the line on inflation or at least slow it down. But as I have said, a primary bear market is a very different kind of animal, and bear markets don't work the way bull markets do. Once this economic slump gets a head of steam on it (and we are fast approaching that stage), we may have all the "inflation-containment" anyone could wish for.

Everyone is convinced that the Government can halt a recession, turn a depression around, reverse a slump. They can — if the downturn occurs within a bull market. But this primary bear market is presenting massive problems, and I do not think Government (with all its power) is going to halt it. We're at the stage where each time one button is pushed, two others light up. However, I can guarantee one thing, as far as the Government is concerned, and that is that they are going to produce whopping, unbelievable deficits. These will occur as our leaders spend and spend in the face of a drop-off in Government tax receipts (no profits, no income, equals no receipts). This is undoubtedly the reason why our Treasury favors "an extension" of the gold legalization act. They are afraid of an American panic out of dollars (into gold), once the sheer size of the coming deficits is comprehended.

In the final analysis, what everyone is avoiding is pain. The people have opted for higher wages, higher prices, fiat money, bigger cars, bigger houses, bigger deficits, and bigger economic lies. The politicians have given it all to them. The country is not running on what it needs or can afford, it is running on what it wants and what it can borrow. Now we're in a primary bear market, and the bear is forcing us to face reality and to pay the piper.

But that's painful. It involves sacrifice, hard work, saving, planning ahead. The nation is slowly but relentlessly coming face to face with the great choice, whether to roll up its sleeves and get down to reality — or whether to try to keep the balloon rising. Every four-year old knows that a hot-air balloon will rise until it self-destructs. But does Washington know?

LOSERS: I recently saw the movie, "The Gambler," in which James Caan played a man caught up in a nightmare world of his own making. He owes $44,000 to the Mafia, and when he finally borrows the money from his tormented mother, he loses it again (to the audience's horror). One of the Mafia men, already well aware of what is in store for Caan, says, "I've seen dozens of you guys. And ya know, you all have one thing in common." Caan shrinks into his chair, "Yeah, I know," he answers, "we all want to lose."

Naturally, I immediately related this to my experiences with many subscribers and the stock market. Many people seem to have a deep, totally unconscious desire to lose their money (strange as this may sound). It stems, as a rule, from unexpressed feelings of guilt. "A man who is free of guilt and anxiety is a healthy man," wrote Sigmund Freud. I believe it.

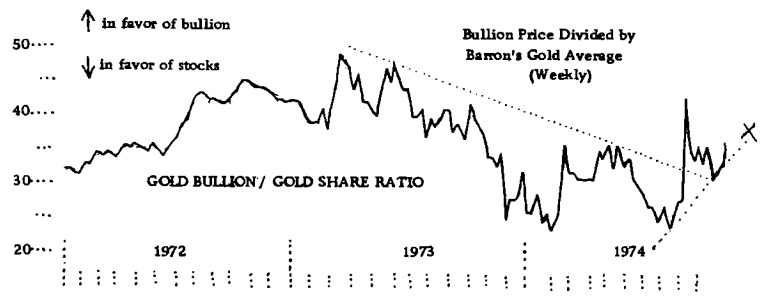
The man who (on a deep level) dislikes himself, feels he is "no good," is usually suffering from neurotic guilt. There are a number of ways of easing that guilt. He can (1) share it with someone else, such as a priest, a friend, (2) he can punish himself through physical pain such as an accident, (3) he can make himself sick, punish himself through illness, (4) he can become a loser, like the man who consistently loses money in the stock market.

Now, there are intelligent losses and neurotic losses. When a stock or the market isn't doing what you believe it should be doing, and you sell out at a loss, that can be a very intelligent loss (often the first loss is the best loss). At other times, the reasons for buying a stock may have actually changed, and you may then have to take an intelligent loss.

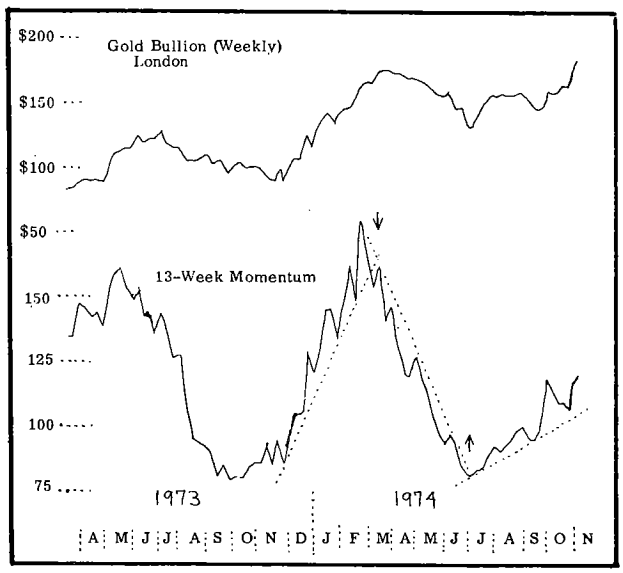
But there are neurotic (and unconsciously) punishing losses as well. For instance, there are many stock market adages which seek to point out that just as there is a time to buy, there is a time to sell. "A bull makes money, a bear makes money, a pig makes nothing." "Nobody loses taking a profit." "Only the gamblers and liars sell at the highs." The fact is that Wall Street is always there, but it is never there just to make life easy for you. People often tell me that "Wall Street owes them this or that". Wall Street owes you nothing. At various times, Wall Street offers excellent investments, at other times, Wall Street is overpriced, and at still other times Wall Street isn't offering the prudent investor a blasted thing.

Why am I talking about losses when most advisory services talk about nothing but profits and how you can make a killing? Because losses are as much a part of this business as gains. People have been calling me, telling me they "can't get the impetus up to get off margin" (I never told anyone to get on margin), that they "can't take profits or losses," that they'll just "wait and see what happens". Recently, I said, "Cut back to 25% to 40% in your total gold position regardless of gain or loss." That's the way I saw it, and I still see it that way now.

GOLD: In case you haven't guessed, the gold picture is becoming more and more complicated. On November 8 gold bullion in London rose over the old $179.50 peak and pushed into record high territory. It did so in a most convincing way, running up to 183, coming back to test 180, then rallying up into the high 180's. Those who were predicting a "double top" at 180 were forced to eat their words. So far, gold shows no signs of "coming tumbling down".



I am including my chart (Friday second London fixing) of gold plus the 13-week momentum line. The momentum is calculated by dividing the Friday price by the price of gold 13 weeks previous. The "up-arrow" in early July shows where momentum turned up, giving a bull signal for gold bullion (this was discussed earlier, prior to the rise above 160, see Letter 612). The latest momentum figure is 121 as of November 15, It will be most important to watch the gold momentum index from this point on. As long as momentum holds above the rising trendline, it will be a major technical plus for gold. It would take a current price of under 165 for gold to break the momentum trendline. In other words, as long as gold holds above 165, the picture is bullish. If the gold momentum breaks below the trendline, we could have a week or as much as a month's lead time before gold itself actually turns down. That is the great value of the momentum index. I will provide the critical gold momentum figures in each report from here on.



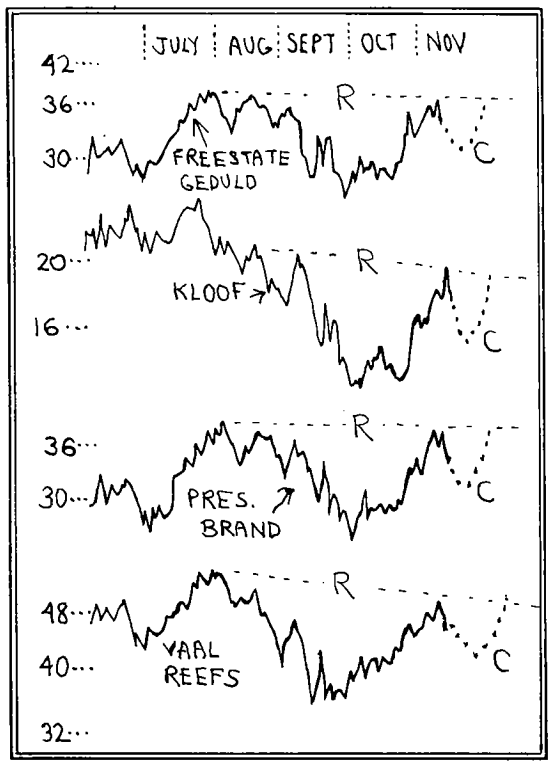
The obvious big question now is "Why has gold taken off while the gold shares have been acting soggy?" First, let's look at the gold bullion/ gold share ratio chart and see what actually is happening. Last week, the ratio rose to 37, still above the trendline, but hardly a dramatic rise. Nevertheless, I have drawn a rising trendline in favor of bullion (trendline X), and let's say this trendline holds. What could this mean? First, it could mean that people are getting scared of all corporate entities, scared of anything they can't hold in their hands or bury in their backyards. Thus, they would want the metal, not the shares. Second, it could mean that the shares are discounting some forthcoming world fix or top in the price of gold, say a price of $220. Thus, the best could have already have been discounted by the shares, even while bullion moves up to meet its predestined price. Third, the shares are, in my opinion, overdue to correct, and I said this in the last report. But the powerful move in bullion may have served to hold off the correction.

Fourth, foreigners may be buying bullion while foresaking the shares. Many foreign investors are used to dealing in gold, but they are skeptical of the shares. Fifth, gold bullion could be running up in anticipation of the American legalization of gold. The stocks might not care for this kind of "anticipation move," and the play might be largely confined to the metal. Sixth, the stocks may now be discounting deflation and world depression, and thus the inflation argument for gold would be temporarily over or held in abeyance. In that case, investors might want bullion and coins for strict survival value, but they would not see the shares themselves as safe enough to represent a survival vehicle. Seventh, investors may not trust the new explosion in gold bullion to the "over 180" level; they may not believe 180 will hold. It could be that gold would have to push over 200 before investors would actually believe the new gold level. Then, a new rush to gold shares could start, and it could erupt "out of the blue".

Which of these concepts do I believe? My own guess is that the investors are suspicious of the gold price over 180, although I personally believe the gold move is absolutely legitimate. I also think that the shares are now discounting the "unexpected" spector of delfation, and many investors reason as follows: "Deflation may take six months to a year to become apparent, or it could take that long before governments recognize that deflation, not inflation, is the problem. Then they would start priming the money pumps. But there could be a good lag between now and the time when monetary inflation is used to combat depression and price deflation. During that lag period, gold shares could go down. I can buy gold coins or bullion, squirrel it away and forget about it, but I can't forget about the shares. Too many worries there. So I'll move from shares to bullion, and just wait it out that way."

Finally, if I am correct, if the gold bullion move is "for real," and gold is going to march well over 200, then there may be a sudden recognition on the part of investors as follows, "Good Lord, this is a whole new ball game. Gold is actually over 200, and it looks like it's going to stay there. They're not just "putting it there' so they can sell it to the Americans in 1975. It's really an over-200 dollar item. At 200 dollar gold, the shares are a bargain". And at that point, we could see a real (bullish) change in sentiment toward the gold shares.

Next question, what to do? I have been discussing many of these problems, and these problems are behind the reason I suggested cutting back to 25% to 40% in gold related items, with the total gold kit made up of both gold coins and gold shares. I would say that subscribers can forget about their positions in low-premium gold coins. This is the ultimate monetary survival vehicle. The coins will constitute money when your grandchildren are paying for their chewing gum with $50 dollar bills or Ecrus or funny-money box-tops or whatever they use at that time (who knows, maybe deflation will have taken over, and they'll be buying gum with pennies and nickels again). But the gold shares represent corporate ownership, and as such are not real money; they are shares in producers of real money. As I have said before, you can bury Austrian Coronas in your backyard, but no matter where you hide the shares, you still have to depend on the Canadian government if you own Dome, or the South African government if you own West Driefontein (mind you, I'm not saying S. African capitalism won't outlast ours).



I am including daily charts of four typical S. African gold shares (tracings from Kaffir Chart Service, Palisades Pk, NJ 07650). The charts cover the stock action since July. In each case, we see the July-September drop, then the rise from the September lows. I have drawn horizontal dashed trendlines labeled R in each case, and the R stands for resistance. I feel that the move up to the resistance trendlines has been very fast, and that it should be corrected.

The dotted formations labeled C stands for potential correction. I believe that a C-type correction would add greatly to the technical structure of these shares, and this is what we may be heading into. If we get a C-type "right shoulder" structure, then we would have what appears to be head-and-shoulder bottoms on the golds. In the event that these shares back off, then push up (in other words, if they follow the C patterns), we could get a further major rise in the shares. If the shares rise from here (on the basis of higher gold prices), I would say that the rise will be less impressive.

What if the shares back off, sink, and then go into limbo? I would say that such action would be discounting forthcoming deflation, perhaps severe deflation. In that case, it would probably be a wait of six months or more before the next major upward move in the gold shares, a move based on a world attempt to reflate the various economies out of depression.

LATE NOTES: (Nov. 18): British market down 6.9 points, down to another horrendous 16-year low. Gold at a record "over 190" with silver cracking, going the way of the rest of the commodities. US market reeling with the "right shoulder" of the famous "head-and-shoulders bottom" now thoroughly fractured. My PTI also broke to a new bear market low today. GM fell through 32-5/8 to register another 17-year low. The news consists of a long recital of factory lay-offs and shutdowns, with the 1975 cars backing up at a ghastly rate. President Ford is rushing around overseas for no sane reason that I can discern, but maybe we're safer with Mr. Ford out of the country. As we move into the third phase of the great bear market, investors are slowly realizing that this may not be recession we are facing, it may be depression. One ominous aspect: consumers instead of saving (usual recession procedure) are now dipping into savings because they need the money. This is a third phase depression phenomenon. I keep hearing pundits saying, "Well, there's one thing ah'm sure of, and it's that we're not facing another 1930's kind of collapse." First, how the hell do they know? And second, I wish the politicians and economists would stop "comforting" us with those words. Whenever three or more politicians or economists (particularly Administration economists) agree on anything, I write if off as an impossibility or a lie.

BONDS: I want to slip in a word about bonds here. I think that we are going into a period of massive new deficits with the next US Federal deficit to run much over $20 billion. I watch the bond rally, and I think, "The bond push is on borrowed time. The guys buying the bonds here are probably the same institutional managers who got pulverized in common stocks over the past six years. They sold their mistakes and switched to bonds! Just as they thought stocks were a great buy in 1968 and 1970, they think bonds are a great buy now. I feel the switch into those 'juicy, high-yield bonds' is going to prove just as wrong as the big move into stock in the late 1960's and early 1970's.

NOTE: I am going to take two weeks between this mailing and the next one. The next report will go out December 4. I want to repeat that I cannot provide personal advice, and I cannot answer the majority of fine letters received here. I do not give advice, because I don't believe one man can think or do homework for another. Each man has a different make-up, and different problems. What I do myself may make absolutely no sense for you. I cannot answer all the letters received here because I simply don't have the time or energy. But I read every single letter, and I appreciate each of them (often, the information received proves invaluable, so a large thanks to all subscribers who write).